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Message Text

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OMB-01 DOE-15 /123 W
----------028978 231435Z /40
R 231304Z JUN 78
FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC PRIORITY 7848
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY LONDON
AMEMBASSY PARIS
AMEMBASSY ROME
AMEMBASSY TOKYO
AMCONSUL MONTREAL
ALL OTHER CONGENS IN CANADA (BY POUCH)

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USEEC

PARIS ALSO FOR USOECD

PASS TREASURY FOR SYVRUD

E.O. 11652: NA
TAGS: ECON, EFIN, CA
SUBJECT: ECONOMIC OUTLOOK FOR CANADA THROUGH MID-1979

REF: OTTAWA 1746

1. SUMMARY. OVER THE NEXT TWELVE TO EIGHTEEN MONTHS, WE EXPECT THE CANADIAN ECONOMY WILL REMAIN LARGELY STALLED
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AT A SLOW TO MODERATE ECONOMIC GROWTH RATE NEAR FOUR PERCENT, INSUFFICIENT TO REDUCE UNEMPLOYMENT FROM CURRENT LEVELS ABOVE EIGHT PERCENT. INFLATION MEASURED BY CONSUMER PRICES HAS WORSENED, BUT THE UNDERLYING RATE HAS SHOWN STEADY IMPROVEMENT, AND BY SOME MEASURES IS NOW BELOW SIX PERCENT. THIS TENDENCY MAY BE REVERSED OVER THE NEXT YEAR AS FOOD PRICE INCREASES MODERATE, BUT WAGE

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SETTLEMENTS INCREASE AND INCREASE UNDERLYING COST PRESSURES. SOURCES OF GROWTH FOR THE REST OF 1978 WILL REMAIN MOSTLY THE FOREIGN SECTOR AND PRIVATE CONSUMPTION. REAL PRIVATE INVESTMENT GROWTH THIS YEAR WILL BE CLOSE TO ZERO BUT SHOULD INCREASE BY THE END OF NEXT YEAR AS CAPACITY UTILIZATION RATES INCREASE. FOREIGN DEMAND, MOSTLY EXPORTS TO THE U.S., WILL LEVEL OFF NEXT YEAR AND WILL PROBABLY CEASE TO BE AN IMPORTANT SOURCE OF GROWTH. THE FEDERAL GOVERNMENT FEELS CONSTRAINED BY AN EXISTING LARGE DEFICIT, PERSISTENT INFLATION, AND A WEAK DOLLAR FROM TAKING MUCH MORE DIRECT ACTION TO STIMULATE THE ECONOMY, AND HAS CONCENTRATED INSTEAD ON COOPERATION WITH PROVINCES TO REDUCE SALES TAXES AND STUDYING POLICIES FOR MEDIUM TERM STRUCTURAL CHANGE. THE SALES TAX REDUCTION WHICH IS DUE TO EXPIRE IN OCTOBER MAY WELL BE EXTENDED.

2. SPURRED BY DEPRECIATION OF THE CANADIAN DOLLAR THE MERCHANDISE TRADE SURPLUS WILL CONTINUE TO EXPAND DURING THE COURSE OF 1978 TO ABOUT CDOLS 4.2 BILLION, BUT CANNOT BE EXPECTED TO INCREASE MUCH FURTHER NEXT YEAR. WITH SERVICE PAYMENTS CONTINUING TO GROW, THE CURRENT ACCOUNT DEFICIT WILL EXPAND FROM ABOUT U.S.DOLS. 3.8 BILLION THIS YEAR TO A RATE OF ABOUT 4.2 BILLION IN THE FIRST HALF OF NEXT YEAR. END SUMMARY.

3. CONSUMPTION: REAL CONSUMPTION SPENDING SHOULD RISE
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BY ABOUT 3.75 PERCENT THIS YEAR. WE CONTINUE TO EXPECT 0.5 PERCENT RISE IN REAL AVERAGE EARNINGS, 2 - 2.5 PERCENT INCREASE IN EMPLOYMENT AND 3 - 3.5 PERCENT ADVANCE IN DISPOSABLE INCOME. CONTINUED HIGH UNEMPLOYMENT RATE AND HIGH INFLATION RATE WILL MILITATE AGAINST DROP IN SAVINGS RATE ASSUMED IN PREVIOUS FORECAST. HOWEVER, POSSIBLE ABSENCE OF DECLINE IN SAVINGS RATIO SHOULD BE OFFSET BY STIMULATION PROVIDED BY CUTS IN PROVINCIAL SALES TAXES IMPLEMENTED IN APRIL.

4. CONSUMPTION SPENDING SHOULD SHOW ACCELERATING TREND THROUGH 1978 AND INTO 1979. BUYING SURGE (OF UNCERTAIN MAGNITUDE) SHOULD OCCUR IN THIRD QUARTER IN ANTICIPATION OF RETURN OF SALES TAXES TO HIGHER LEVELS. ASSUMING SOME DECELERATION IN RATE OF FOOD PRICE INCREASE (NOT TOTALLY OFFSET BY INCREASE IN SALES TAXES IN SEPTEMBER), CPI RISE SHOULD TAPER OFF, AND HENCE, REAL INCOMES SHOULD GROW MORE RAPIDLY. FINALLY, WAGE INCREASES COULD WELL PROCEED SOMEWHAT MORE RAPIDLY AS CONTROLS ARE PHASED OUT, AND LABOR SEEKS TO RECOUP DECLINE IN REAL WAGES EXPERIENCED OVER LAST HALF YEAR. THUS, REAL DISPOSABLE INCOMES COULD INCREASE AT ANNUAL RATE OF 5 PERCENT IN FIRST HALF OF

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1979.

5. INVESTMENT: OUTLOOK FOR PRIVATE INVESTMENT SPENDING HAS DARKENED FURTHER. DEGREE OF EXCESS PRODUCTIVE CAPACITY INCREASED FURTHER IN FIRST QUARTER. PRODUCTION AND PROFIT TRENDS CONTINUE SLUGGISH (ALTHOUGH NEW ORDERS AND RETAIL SALES PICKED UP A BIT IN APRIL) AND WEAK DEMAND CONTINUES AS MAIN DETERRENT TO INVESTMENT. PRIVATE SURVEYS CONTINUE TO SHOW THAT BUSINESS IS MORE OPTIMISTIC ON SALES AND PROFIT OUTLOOK, BUT RELUCTANT TO INVEST DUE TO SUBSTANTIAL SPARE CAPACITY. RESIDENTIAL CONSTRUCTION SPENDING IS UNLIKELY TO SHOW ANY YEAR ON YEAR GROWTH. WE NOW EXPECT PRIVATE INVESTMENT TO STAGNATE IN REAL TERMS THIS YEAR.

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P 231304Z JUN 78
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TO SECSTATE WASHDC PRIORITY 7849
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY LONDON
AMEMBASSY PARIS
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6. INVESTMENT SPENDING SHOULD PICK UP SLIGHTLY IN 1979, ALTHOUGH TIMING OF PICKUP IS HARD TO CALL. ENERGY INVESTMENT SHOULD BEGIN RECOVERY FROM 1978 HIATUS. STOCK OF EXCESS HOUSING SHOULD HAVE BEEN WORKED DOWN, AND STRONGER GROWTH OF REAL INCOMES WILL BOOST DEMAND. NONETHELESS, MANUFACTURING INVESTMENT WILL CONTINUE WEAK. GROWTH OF REAL PRIVATE INVESTMENT COULD REACH 1.5 - 2 PERCENT AT ANNUAL RATE IN FIRST HALF OF 1979.

7. GOVERNMENT SPENDING AND FISCAL POLICY: ALTHOUGH CUTS IN PROVINCIAL SALES TAXES SHOULD PROVIDE SOME BOOST TO CONSUMER SPENDING, APRIL 10 GOC BUDGET WAS BASICALLY A "NO POLICY CHANGE" DOCUMENT. GOC AND PROVINCES CONTINUE TO EMPHASIZE PUBLIC SECTOR RESTRAINT. THUS, THE GROWTH LIMITED OFFICIAL USE

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OF REAL GOVERNMENT SPENDING SHOULD STAY WELL BELOW THE EXPECTED GROWTH OF REAL GNP FOR BALANCE OF THIS YEAR. ADDITIONAL FISCAL STIMULUS LATER IN 1978 IS A POSSIBILITY IF THE ECONOMY CONTINUES TO GROW SLOWLY AND UNEMPLOYMENT RATE FAILS TO COME DOWN. UNDER THIS SCENARIO, GOC MIGHT INTRODUCE NEW MEASURES EARLY IN FALL SO THAT EFFECTS WOULD COME THROUGH IN FIRST HALF OF 1979 (WHEN THERE MAY BE FEDERAL ELECTIONS). THERE WOULD BE A GOOD CHANCE THAT SALES TAX REDUCTIONS, DUE TO EXPIRE IN OCTOBER, WOULD BE EXTENDED.

8. MONETARY POLICY: EARLIER THIS YEAR, MONETARY POLICY WAS GIVEN OVER TO DEFENSE OF CANADIAN DOLLAR EXCHANGE RATE (SEE OTTAWA 1746). WHILE DOWNWARD PRESSURE ON DOLLAR HAS SINCE EASED AND M1 GROWTH IS WITHIN OFFICIAL 7-11 PERCENT TARGET RANGE, EXCHANGE RATE CONSIDERATIONS CONTINUE AS AN IMPORTANT FACTOR INFLUENCING LEVEL OF DOMESTIC INTEREST RATES. BANK OF CANADA HAS PUSHED SHORT TERM RATES UP SEVERAL BASIS POINTS IN PAST MONTH THROUGH OPEN MARKET OPERATIONS TO PREVENT INTEREST DIFFERENTIAL WITH U.S. FROM NARROWING TO POINT WHERE SELLING PRESSURE ON DOLLAR WOULD DEVELOP. THUS, WHILE BANK OF CANADA WILL CONTINUE TO PURSUE LONG RUN OBJECTIVE OF INDUCING GRADUAL REDUCTION IN INFLATION RATE, SETTING OF MONETARY POLICY AT ANY GIVEN TIME WILL BE IMPORTANTLY INFLUENCED BY STATE OF EXCHANGE MARKETS. M1 GROWTH TARGET RANGE IS LIKELY TO BE REDUCED AGAIN LATER THIS YEAR, MOST LIKELY BY ONE PERCENTAGE POINT TO A 6-10 PERCENT RANGE.

9. INFLATION: DRIVEN BY SURGING FOOD PRICES, INFLATION IS RUNNING AT ANNUAL RATES (SA) OF OVER TEN PERCENT. UNDERLYING RATE, AS MEASURED BY RISE IN NON-FDOD PRICES, IS RISING AT ANNUAL RATE OF ONLY 5.4 PERCENT, DUE IMPOR-

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TANTLY TO MODERATION OF WAGE INCREASE. NEW CONTRACTS IN FIRST QUARTER PRODUCED AVERAGE ANNUAL WAGE INCREASE OF 6.7 PERCENT, COMPARED WITH 7.1 PERCENT IN FOURTH QUARTER 1977. REAL WAGE INCREASES HAVE BEEN NEGATIVE AT THE MARGIN FOR THE PAST HALF YEAR, AS HAS THE GROWTH IN REAL AVERAGE HOURLY EARNINGS.

10. RATE OF INFLATION SHOULD MODERATE SOMEWHAT IN REMAINDER OF YEAR, ASSUMING INCREASE OF FOOD PRICES TAPERS OFF. DIRECT INFLATIONARY IMPACT OF CANADIAN DOLLAR DEPRECIATION HAS LARGELY PASSED AND WILL NOT BE AN IMPORTANT FACTOR IN INFLATION OVER NEXT SEVERAL MONTHS. SOME ACCELERATION OF INFLATION WILL OCCUR IN SPETEMBER WHEN SALES TAXES SET TO RETURN TO HIGHER LEVEL. INCREASES IN ENERGY PRICES, SET FOR JULY, WILL BE PASSED THROUGH TO CONSUMERS IN SEPTEMBER. MAIN DANGER, HOWEVER, IS THAT LABOR WILL SEEK TO RECOUP DECLINES IN REAL EARNINGS AS DECONTROL PROCEEDS. THUS, UNDERLYING INFLATION RATE COULD START TO RISE CONCOMITANTLY WITH DECLINE IN ACTUAL INFLATION RATE. AN ACCELERATION OF INFLATION IN U.S. WOULD ALSO BE FELT IN CANADA. WE CONTINUE TO FORECAST 7.5 PERCENT YEAR OVER YEAR INCREASE IN CPI AND 6.5 PERCENT RISE IN GNP DEFLATOR. IN FIRST HALF OF 1979, CPI AND GNP DEFLATOR MAY BOTH RISE AT 7 PERCENT ANNUAL RATE. FORECAST ASSUMES NO FURTHER SIGNIFICANT CHANGE IN CANADIAN/U.S. DOLLAR EXCHANGE RATE OR EXTENSION BEYOND OCTOBER OF SALES TAX REDUCTIONS.

11. EMPLOYMENT AND LABOR MARKET: EMPLOYMENT HAS CONTINUED TO GROW STEADILY DESPITE SLUGGISH GROWTH OF OUTPUT. LABOR FORCE HAS ALSO EXPANDED RAPIDLY, DUE IN LARGE PART TO STRONG INCREASE IN PARTICIPATION RATE. THUS, UNEMPLOYMENT RATE HAS REMAINED HIGH. THESE TRENDS SHOULD CONTINUE, PRODUCING UNEMPLOYMENT RATE OF 8.5 PERCENT OR MORE IN 1978 AND IN EARLY 1979.

12. CURRENT ACCOUNT: MERCHANDISE TRADE: MERCHANDISE

TRADE SURPLUS INCREASED SHARPLY IN FIRST QUARTER AND RAN

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FM AMEMBASSY OTTAWA
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AT SEASONALLY ADJUSTED ANNUAL RATE OF CDOLS 5.6 BILLION,
BUT SUBSEQUENTLY SLOWED TO ANNUAL RATE OF CDOLS 4.7 BIL-
LION WITH DECLINE IN SURPLUS IN APRIL. INCOME AND PRICE
EFFECTS WILL EFFECT MAGNITUDE AND TIME PROFILE OF MERCHAN-
DISE TRADE THROUGHOUT THIS YEAR AND INTO NEXT.

-----(A) INCOME EFFECTS: THE GROWTH RATE OF CANADIAN
AND U.S. GNP SHOULD CONVERGE SOMEWHAT AS PACE OF CANADIAN
ACTIVITY PICKS UP WHILE THAT IN U.S. TAPERS OFF, PRODUC-
ING A TENDENCY FOR CANADIAN TRADE SURPLUS TO NARROW. U.S.
DEMAND FOR HOUSING AND AUTOS, OFTEN USED AS PROXIES FOR
CANADIAN EXPORT DEMAND TO THE U.S., ARE EXPECTED TO BE
STRONG THIS YEAR, BUT NOT TO ACCELERATE MUCH FROM 1977
LEVELS. COMPOSITION OF U.S. DEMAND GROWTH THUS IS UNFAVOR-
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ABLE FOR CANADIAN EXPORT GROWTH BUT LEVEL AND COMPOSITION OF
CANADIAN GROWTH ALSO WILL TEND TO HOLD DOWN IMPORTS. DE-
MAND WILL GROW SLOWLY.MOREOVER INVESTMENT, WHICH HAS HIGH
IMPORT CONTENT, WILL BE FLAT THIS YEAR AND RISE MODERATELY

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IN FIRST HALF OF 1978.

---(B) PRICE EFFECTS: "J CURVE" EFFECT OF CANADIAN DOLLAR DEPRECIATION WHICH ACTED INITIALLY TO REDUCE THE MERCHANDISE TRADE SURPLUS HAS CLEARLY GIVEN WAY TO POSITIVE VOLUME EFFECTS. HOWEVER, RESTRAINING INFLUENCE OF DEPRECIATION ON GROWTH OF IMPORT VOLUMES WILL GRADUALLY DECLINE IN REST OF 1978 AND WILL ESSENTIALLY BE ABSENT BY FIRST HALF OF 1979. POSITIVE EFFECT ON EXPORTS SHOULD CONTINUE THROUGHOUT FORECAST PERIOD SINCE EXPORTS REACT TO DEPRECIATION WITH LARGER LAGS THAN IMPORTS. NONETHELESS, PRICE EFFECTS WILL REINFORCE INCOME MOVEMENTS IN CAUSING TRADE SURPLUS TO SHRINK.

---(C) OTHER FACTORS: RECENT CONTRACT FOR SALE OF 3 MILLION TONS OF WHEAT TO PRC IS WORTH CDOLS 0.5 BILLION OVER 18 MONTHS BEGINNING SEPTEMBER. AMOUNT OF CONTRACT ROUGHLY SAME AS CONTRACT DUE TO EXPIRE IN SEPTEMBER. THUS, NEW SALE DOES NOT GENERATE INCREASE IN EXPORT GROWTH (ALTHOUGH ABSENCE OF NEW CONTRACT OBVIOUSLY WOULD HAVE PRODUCED DECLINE).

13. BASED ON ABOVE CONSIDERATIONS, WE PROJECT 6 PERCENT YEAR OVER YEAR RISE OF EXPORT VOLUMES (4-4.5 PERCENT THROUGH THE YEAR) IN 1978 AND 3.5 PERCENT ANNUAL RATE OF INCREASE IN FIRST HALF OF NEXT YEAR. EXPORT VALUE SHOULD RISE BY 15 PERCENT TO CDOLS 51.3 BILLION IN 1978 AND BY ANOTHER 10 PERCENT TO ANNUAL RATE OF CDOLS 56.4 BILLION IN FIRST HALF OF 1979. YEAR OVER YEAR, IMPORT VOLUMES
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SHOULD RISE BY 1 PERCENT IN 1978 (4 PERCENT THROUGH THE YEAR) AND AT ANNUAL RATE OF 4 PERCENT IN FIRST HALF OF 1979. IMPORT VALUES MAY RISE BY 13 PERCENT AND 11 PERCENT TO TOTAL CDOLS 47.1 AND CDOLS 52.3BILLION RESPECTIVELY IN THESE PERIODS.

14. ESTIMATED MERCHANDISE TRADE SURPLUS IS THUS CDOLS 4.2 BILLION IN 1978 AND DECLINES SLIGHTLY TO AN ANNUAL RATE OF CDOLS 4.1 BILLION IN FIRST HALF OF 1979.

15. THE SERVICE DEFICIT WILL CONTINUE TO RISE STEADILY OVER NEXT FOUR QUARTERS, MOSTLY DUE TO RISING INTEREST PAYMENTS ON FOREIGN BORROWING. THE TRAVEL DEFICIT CAN BE EXPECTED TO RISE, BUT ONLY SLOWLY. SO FAR, DEMAND FOR TRAVEL HAS PROVEN TO BE RATHER PRICE INELASTIC AS THE DEPRECIATION OF THE CANADIAN DOLLAR HAS FAILED SO FAR TO REVERSE THE TRAVEL DEFICIT, ALTHOUGH GROWTH OF THE DEFICIT HAS SLOWED. TRAVELORS RETURNING TO CANADA FROM THE U.S. SHOWED LITTLE CHANGE IN THE FIRST FOUR MONTHS OF THIS

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YEAR COMPARED TO THE SAME PERIOD A YEAR AGO, WHILE THE NUMBER OF AMERICANS ENTERING CANADA IN THE SAME PERIOD ACTUALLY DROPPED.

16. THE STEADY RISE IN THE SERVICE DEFICIT, AND SLACKENING OFF OF GROWTH IN MERCHANDISE TRADE SURPLUS EXPECTED IN THE FIRST HALF OF NEXT YEAR, INDICATE THAT THE CURRENT ACCOUNT DEFICIT SHOULD OPEN UP A BIT FROM ABOUT CDOLS 4.2 BILLION THIS YEAR (U.S.DOLS 3.8 BILLION) TO A RATE OF ABOUT CDOLS 4.7 BILLION (U.S.DOLS 4.2 BILLION) EARLY NEXT YEAR.

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ALL OTHER CONGENS IN CANADA (BY POUCH)

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17. TABLES:
A. GNP AND COMPONENTS: MILLIONS OF CONSTANT 1971 DOLLARS, PERCENT CHANGES SHOWN IN BRACKETS ():

	1977 FINAL	1978F	1979I
		(ANNUAL RATE)	
PRIVATE CONSUMPTION:	77,399	80,495	84,520
		(4.0)	(5.0)

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PRIVATE INVESTMENT: 23,390 23,390 23,741
(0) (1.5)

GOV'T. SPENDING: 26,207 26,836 27,480
(2.4) (2.4)

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INVENTORIES: -23 400 450

FOREIGN BALANCE (#): - 4,661 - 3,829 - 4,238

FINAL DEMAND: 122,584 126,892 131,503
(3.5) (3.6)

$9.3 58: $3.-,$: 127,222 131,121 136,191
(3.1) (3.9)

RESIDUAL ERROR: 249 -- --

GNP: 122,561 127,292 131,953
(4.0) (3..7O

(#) NET EXPORTS OF GOODS AND SERVICES.

B. SELECTED INDICATORS:

CPI 8.0 7.5 7.0

GNP DEFLATOR 6.6 6.5 7.0

UNEMPLOYMENT RATE 8.1 8.5 8.5

C. CURRENT ACCOUNT BALANCE, BILLIONS OF CANADIAN DOLLARS.
BRACKETS () INDICATE DEFICIT:

---------- 1978F 1979F

MERCHANDISE TRADE: 4.2 4.1

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SERVICE BALANCE: (8.8) (9.3)
OF WHICH:
INTEREST & DIVIDENDS (4.2) (4.6)

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TRAVEL	(1.9)	(2.0)
OTHER	(2.7)	(2.7)
BALANCE OF GOODS AND SERVICES:	(4.7)	(5.2)
CURRENT ACCOUNT ENDERS	(4.2)	(4.7)

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Review Exemptions: n/a
Review Media Identifier:
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TAGS: ECON, EFIN, CA
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vdkvgwkey: odbc://SAS/SAS.dbo.SAS_Docs/437ba182-c288-dd11-92da-001cc4696bcc
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